

DOCUMENT RESUME

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[Payments on Air Force Aircraft Maintenance Contracts Violate Cost-Plus-a-Percentage-of-Cost Prohibition]. PSAL-78-55; B-169217. January 12, 1978. 6 pp.

Report to Secretary, Department of Defense; by Richard W. Gutman, Director, Procurement and Systems Acquisition Div.

Issue Area: Federal Procurement of Goods and Services (1900); Federal Procurement of Goods and Services: Reasonableness of Prices Under Negotiated Contracts and Subcontracts (1904).

Contact: Procurement and Systems Acquisition Div.

Budget Function: National Defense: Department of Defense - Procurement & Contracts (058).

Organization Concerned: Department of the Air Force; E-Systems, Inc.; Hayes International Corp., Birmingham, AL; Aero Corp., Lake City, FL.

Congressional Relevance: House Committee on Armed Services; Senate Committee on Armed Services.

Authority: Armed Services Procurement Act of 1947, sec. 4(b) (62 Stat. 21; 10 U.S.C. 2306(a)).

Five aircraft maintenance contracts were examined to evaluate the administration of unscheduled work and the payments for contractor-furnished materials. The five contracts were with E-Systems, Inc. (2 contracts); Hayes International Corp. (2 contracts), and Aero Corp.; they were awarded by the Air Force for programmed depot maintenance and modification of aircraft in the Special Air Mission Fleet and the KC-135, C-130, and F-4 aircraft. Findings/Conclusions: Unscheduled work was found to be administered satisfactorily. Regulations prohibit use of the cost-plus-a-percentage-of-cost system of contracting. Payments for certain contractor-furnished materials on the two contracts awarded to E-Systems, Inc., violated the prohibition against this type of payment. E-Systems was reimbursed for indirect expenses and profit on the basis of fixed, predetermined rates. In addition, the Air Force agreed to pay an uncertain sum for materials since the contracts did not provide a specific sum to be spent for contractor-furnished materials. The other three contracts contain similar payment provisions for contractor-furnished materials and may be in conflict with the regulations. Recommendations: In view of the fact that illegal contract payment provisions have been used for overhaul and repair work and for contractor-furnished materials, the Secretary of the Air Force should: (1) determine the amounts properly allowable under the contracts involved and recover any excess payments; and (2) review all aircraft maintenance contracts and eliminate the cost-plus-a-percentage-of-cost system of contracting. (RRS)



UNITED STATES GENERAL ACCOUNTING OFFICE

WASHINGTON, D.C. 20548

PROCUREMENT AND SYSTEMS
ACQUISITION DIVISION

04688

B-169217

JAN 12 1978

The Honorable
The Secretary of Defense

Dear Mr. Secretary:

We examined five aircraft maintenance contracts to evaluate the administration of unscheduled work and the payments for contractor-furnished materials. We found that unscheduled work was generally being administered satisfactorily, but payments to the contractor for certain contractor-furnished materials on two contracts awarded to E-Systems violated the statutory prohibition against a cost-plus-a-percentage-of-cost system of contracting. The other three contracts also contain similar payment provisions for contractor-furnished materials. Therefore, these contracts may also be in conflict with the governing statutes and regulations.

We are recommending that the Secretary of the Air Force determine the amounts properly allowable under the two contracts for contractor-furnished materials and recover any excess contract payments. The Secretary of the Air Force should also review all aircraft maintenance contracts to eliminate cost-plus-a-percentage-of-cost systems of contracting. The essential details of our findings follow.

BACKGROUND

The contracts examined were awarded by the Air Force for programed depot maintenance and modification of the aircraft in the Special Air Mission (SAM) Fleet and the KC-135, C-130, and F-4 aircraft. These contracts were selected because of their high annual dollar value. The contractors and their locations were:

--E-Systems, Inc., Greenville Division,
Greenville, Texas.

--Hayes International Corp., Birmingham,
Alabama (two contracts).

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--Aero Corp., Lake City, Florida.

--E-Systems, Inc., Donaldson Division,
Greenville, South Carolina.

Programed depot maintenance is depot-level modification and maintenance of aircraft normally scheduled on a cyclic basis. Contracts for this service involve two types of work: "basic" and "over and above." The basic work represents known requirements and is awarded on a fixed-price basis. Over and above work requirements are determined after a detailed inspection of each aircraft and are accomplished at the direction of the administrative contracting officer. Payment for over and above work is based on fixed hourly labor rates set forth in the contracts, and the labor hours required for each work order are determined before the work is begun.

Contractor-furnished materials for the over and above work were acquired either by overhauling components removed from the aircraft or purchasing new components. Work on components found to need overhaul and repair was accomplished by approved vendors and subcontractors under fixed-price purchase orders.

COST-PLUS-A-PERCENTAGE-OF-
COST SYSTEM OF CONTRACTING

Section 4(b) of the Armed Services Procurement Act of 1947, February 19, 1948 (62 Stat. 21, c. 65, 10 U.S.C. s2306(a)), provides that the cost-plus-a-percentage-of-cost system of contracting shall not be used. The purpose of this prohibition is to prevent "the increased cost which a contractor might allow to accrue in order to obtain the percentage of the increased cost." 1/

Consistent with the statutory prohibition, the Comptroller General has stated that the cost-plus-a-percentage-of-cost system of contracting is illegal. 2/

1/ National Electronics Laboratories, Inc. v. United States, 180 F. Supp. 337, 148 Ct. Cl. 308 (1960).

2/ 35 Comp. Gen. 434 (1956); 38 Comp. Gen. 38 (1958); 46 Comp. Gen. 612 (1967); and 55 Comp. Gen. 554 (1975).

On the basis of court rulings and Comptroller General decisions, contractual arrangements containing the following features constitute a prohibited cost-plus-a-percentage-of-cost system of contracting: (1) payment is based on a predetermined percentage rate, (2) the predetermined percentage rate is applied to the actual performance cost, (3) contractor's entitlement is uncertain at the time of contracting, and (4) entitlement increases commensurately with increased performance cost. ^{1/} On the basis of this criteria, we believe that payments for certain contractor-furnished material were made on the two E-Systems contracts on a prohibited cost-plus-a-percentage-of-cost system of contracting.

SAM Fleet contract

We found that payments made to E-Systems (Greenville Division), for direct materials purchased under the SAM Fleet contract did not violate the cost-plus-a-percentage-of-cost prohibition. However, payment provisions for materials overhauled and repaired by subcontractors contain all the elements of a cost-plus-a-percentage-of-cost contract.

Direct materials obtained by the contractor were cost reimbursable. This meant that the contractor was reimbursed for the cost of materials plus general and administrative expenses involved with the purchase. The rates used to determine general and administrative expenses had to be audited yearly, and retroactive adjustments were made to reflect actual costs. No profit to the contractor was allowed on these purchases. While this payment arrangement is permissible, we do not believe it is a good procedure because the contractor has no incentive to control costs.

On the other hand, during the 40-month life (May 1973 through September 1976) of the contract, predetermined percentage rates for procurement support, general and administrative expense, and profit were applied by E-Systems, after the fact, to invoice amounts billed by subcontractors for materials overhauled and repaired. For this same period, the procurement support and general and administrative expense rates ranged from 3.4 to 7.1 percent and 14.5 to 20.1 percent, respectively, on the basis of negotiated forward-pricing rates. Although these rates changed during the contract period, the amounts resulting from the rate application were not subject to any retroactive adjustment to actual costs.

^{1/} 55 Comp. Gen. 554 (1975).

Additionally, E-Systems added profit at a fixed percentage rate to these invoices after the addition of amounts for procurement support and general and administrative expense. During the first year of the contract, a 10-percent profit rate was used for all purchase orders originating from either the E-Systems facility at Greenville, Texas, or the contractor's liaison office located at Andrews Air Force Base, Camp Springs, Maryland.

In March 1975, a separate 8-percent profit rate was negotiated for all purchase orders originating from the liaison office at Andrews Air Force Base. This rate was applied to all invoice prices for subcontracted component overhaul and repair work during the second and third year of the contract plus a 3-month option period. The 10-percent profit rate, previously negotiated, remained in effect for all purchase orders issued from the Greenville, Texas, facility.

The cost for materials overhauled or repaired by subcontractors increased during the first year of the contract from an estimated amount of \$1,118,000 to \$1,634,000, or about 46 percent. The invoice cost for such materials totaled \$4.6 million over the life of the contract. In addition to this cost, we estimated that about \$1 million was paid for procurement support and general and administrative expenses. This amount was based on the negotiated predetermined percentage rates previously mentioned. Profit rates were then applied, resulting in a \$500,000 profit to E-Systems for subcontracted overhaul and repair work.

F-4 contract

The F-4 contract with E-Systems (Donaldson Division) provides for the reimbursement of contractor-furnished materials on a price-negotiated basis. This method permits the contractor to recover general and administrative expenses and to receive a profit on material purchases. In October 1975, the procuring contracting officer and the administrative contracting officer negotiated with the contractor a 23-percent rate for general and administrative expense and a 6-percent rate for profit. The rates were fixed for the entire contract period and applied to all material invoice prices. No retroactive adjustments were made to these rates to reflect actual costs.

Contractor-furnished material costs, plus the percentage allowance for general and administrative expense and profit, were estimated at \$17,300 in October 1975. In March 1977, after the Air Force made two significant contract modifications, these costs had increased to about \$536,300. This \$519,000 increase will allow the contractor to recover an additional \$92,000 in general and administrative expense and \$29,000 in profit.

CONCLUSIONS

The payment provisions for subcontracted overhaul and repair work for the SAM Fleet contract and direct material purchases for the F-4 contract contain all the elements of a cost-plus-a-percentage-of-cost contract. In this regard, E-Systems was reimbursed for indirect expenses and profit on the basis of predetermined, fixed percentage rates. These predetermined percentage rates were applied and added to the invoice price for materials. Because the contracts did not provide a specific amount to be spent for contractor-furnished materials, the Air Force in effect agreed to pay an uncertain sum for these material costs plus a fixed percentage of that sum, whatever it might be. On this basis, it is clear that payments under the E-Systems contracts will increase commensurately as those predetermined percentage rates are applied to increased performance costs.

The other three aircraft maintenance contracts surveyed contained payment provisions similar to those in the E-Systems contracts.

RECOMMENDATIONS

In view of the fact that illegal contract payment provisions have been used for subcontracted overhaul and repair work and for other contractor furnished materials, we recommend that the Secretary of the Air Force determine the amounts properly allowable under the contracts involved and recover any excess payments.

We also recommend that the Secretary of the Air Force review all aircraft maintenance contracts and eliminate the cost-plus-a-percentage-of-cost system of contracting. In this regard, we believe there are several alternatives that should be considered for correcting this problem. In order of preference, they are:

1. Eliminate the allocation of general and administrative expenses and profit to material costs. Such charges would be allowed on labor costs because the labor charges are determined early in contract performance.
2. Negotiate a fixed price for materials at the point when the amount of material that will fulfill contract requirements can be determined. This should be as early as possible in contract performance to provide the contractor an incentive to control material costs.
3. Provide for the retroactive revision of general and administrative expenses based on actual material costs incurred. While this alternative would correct the problem, it would not give the contractor an incentive to control costs.

As you know, section 236 of the Legislative Reorganization Act of 1970 requires the head of a Federal agency to submit a written statement on actions taken on our recommendations to the House Committee on Government Operations and the Senate Committee on Governmental Affairs not later than 60 days after the date of the report and to the House and Senate Committees on Appropriations with the agency's first request for appropriations made more than 60 days after the date of the report.

Sincerely yours,



R. W. Gutmann
Director